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CITATIONS

In the Supreme Court of the United States

OCTOBER TERM, 1937

No. —

UNITED STATES OF AMERICA, PETITIONER

v.

L. MANUEL HENDLER, AS TRANSFEREE OF CREAMERIES, INC. (FORMERLY HENDLER CREAMERY CO., INC.)

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

The Solicitor General, on behalf of the United States, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Fourth Circuit, entered in the above-entitled cause on August 7, 1937.

OPINIONS BELOW

The opinion of the District Court (R. 169–189) is reported in 17 F. Supp. 558. The opinion of the Circuit Court of Appeals (R. 200–204) is not yet reported.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered August 7, 1937. (R. 200.) The juris-

diction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The assets of the Hendler Company were transferred to the Borden Company in exchange for stock of Borden, cash, and Borden's undertaking to pay Hendler's debts. Does the payment and discharge by Borden of Hendler's bonded indebtedness result in taxable income to Hendler?

STATUTE INVOLVED

The pertinent provisions of the Revenue Act of 1928 appear in the Appendix, *infra*, pp. 13–15.

STATEMENT

During the spring of 1929, Hendler Creamery Company, Inc., a Maryland corporation engaged in the manufacture and distribution of ice cream, conducted various negotiations with The Borden Company, a New Jersey corporation, with a view to effecting a transfer of all its assets to the latter. An understanding between the parties was reached and embodied in a letter dated April 16, 1929. (R. 143–149.) That letter, however, was superseded by another agreement, dated May 21, 1929 (R. 3–22), and it was the latter agreement which formed the basis for the various transactions here under review (R. 22).

Pursuant to that agreement, Hendler, on June 21, 1929, transferred all its assets to Borden. (R.

151–155, 170.). In consideration therefor, Borden gave to Hendler 105,306[1] shares of its capital stock (out of a total of 3,256,993 shares) and $43,421.87 in cash, all of which Hendler immediately distributed to its stockholders. (R. 32, 35–36, 170.) In addition, Borden "assumed and agreed to pay" all the indebtedness and liabilities of Hendler, subject to certain exceptions not material here. (R. 9, 170.) Shortly thereafter, on June 25, 1929, Hendler changed its name to "Creameries, Incorporated" (R. 32), and was dissolved on August 5, 1930 (R. 35).

As a result of these transactions Hendler realized a profit of $6,608,713.65 (R. 172), most of which, however, the Government did not seek to tax by reason of the reorganization provisions of the revenue law. The present proceeding relates to a portion of that profit which the Government insists was not exempt from taxation.

The agreement provided that Borden would "assume and agree to pay all indebtedness and liabilities whatsoever of your [Hendler] Company" subject to certain exceptions not involved here (R. 9). The outstanding liabilities of Hendler as of June 21, 1929, which were assumed by Borden, consisted of current bank loans ($1,050,000), merchandise accounts ($130,410.78), and $501,000 par

[1] The stipulation (R. 32) declares the number to be 105,306, whereas the District Court's opinion fixes it at 106,306 (R. 170). Nothing, however, is made to turn upon this discrepancy.

value of bonds (R. 170). The present controversy relates merely to the assumption and discharge by Borden of Hendler's bonded indebtedness.

During the early part of the negotiations between Borden and Hendler, the latter had outstanding $675,000 principal amount of First Mortgage bonds (R. 4). These bonds were convertible into Prior Preference stock of Hendler, and by May 15, 1929, a number of the bonds had been so converted, leaving on that date bonds outstanding in the face amount of $501,000 (R. 21).

The bonds were subject to redemption on any interest payment date (interest being payable January 1 and July 1 of each year) on 30 days' notice at 107½% of their principal amount plus accrued interest (R. 4–5).

On May 15, 1929, the board of directors of Hendler voted to call and redeem all the outstanding bonds (R. 66–68), and on the same day notice of redemption was sent to the trustee under the bond indenture (R. 73). Thus the steps necessary to redeem the bonds were started nearly a week before the operative agreement of May 21, 1929, and more than a month before the transfer of assets on June 21, 1929.

Although, in the agreement of May 21, 1929, Borden "assumed" and "agreed to pay" the indebtedness of Hendler, it nowhere appears that any bondholder or other creditor consented to a release of Hendler from liability.

Pursuant to the agreement of May 21, 1929, Borden, on June 27, 1929, undertook to discharge Hendler's obligation on the $501,000 outstanding bonds. Up to June 27, 1929, Borden had acquired $156,000 of those bonds, and in a letter of that date, it instructed the trustee to cancel those bonds on July 1, 1929, without payment. (R. 86.) In the same letter it instructed the trustee to redeem the remaining $345,000 bonds on July 1, 1929, and stated that for that purpose it had deposited with the Guaranty Trust Company of New York the sum of $381,225[2] to the credit of the trustee. In all, Borden effected the discharge of Hendler liabilities by expenditure of $534,297.40 with respect to the bonded indebtedness. (R. 87, 170.)

In its return for 1929 Hendler did not include as taxable income this amount of $534,297.40, representing a discharge of liabilities, nor any part of the $6,608,713.65 profit realized on the exchange with Borden. The Commissioner did not object as to the bulk of the profit on the exchange, but took the position that the reorganization provisions did not exempt the item of $534,297.40. He made a deficiency assessment which was paid by L. Manuel Hendler, as transferee, on April 15, 1933, in the amount of $58,772.72, plus interest in the amount of $10,781.97. (R. 172.)

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[2] Of that amount $345,000 was to be allocated to the face amount of the bonds, $25,875 to cover the premium of $7.50 per $100 bond, and $10,350 to cover accrued interest to July 1, 1929. (R. 86, 157.)

The present suit was filed July 11, 1934, to recover those amounts after a claim for refund had been denied. (R. 2.) The District Court held that the discharge of the taxpayer's bonded indebtedness was not taxable, and ordered a refund, after permitting an offset in the amount of $6,260.33, arising out of a different issue (R. 188–189), which is not now involved. The Circuit Court of Appeals affirmed.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding exempt under Section 112 of the Revenue Act of 1928 the income realized by Hendler Creamery Company as a result of the assumption and discharge by The Borden Company of the Hendler bonded indebtedness.

2. In affirming the decision of the District Court.

REASONS FOR GRANTING THE WRIT

Preliminary.—As a result of the exchange between the Hendler and Borden companies, Hendler realized an undisputed profit of $6,608,713.65. In particular that figure includes the amount of $534,297.40 which represents the assumption and discharge by Borden of Hendler's bonded indebtedness. That amount was properly included since it is clear that the payment of an obligation by another may be income to the one whose debt is discharged. *Douglas* v. *Willcuts*, 296 U. S. 1, 9; *Old*

Colony Tr. Co. v. *Commissioner*, 279 U. S. 716; *United States* v. *Boston & M. R. Co.*, 279 U. S. 732.[3]

Accordingly, if the reorganization provisions (Section 112) were absent from the law, the *entire* profit of $6,608,713.65, including the item of $534,297.40, would be subject to tax under the usual provisions of the statute taxing net income (Sections 21 and 22).[4] This apparently was not disputed by the court below, and the only question is whether Section 112 *exempts* income otherwise taxable under basic provisions in Sections 21 and 22.

There was, of course, a "reorganization" within the meaning of Section 112 i (1) (A), since there was an "acquisition by one corporation [Borden] of * * * substantially all the properties of another corporation [Hendler] * * *." See *Helvering* v. *Minnesota Tea Co.*, 296 U. S. 378, and related cases. But Section 112 i (1) merely *defines* reorganization. The exemption from taxation must be found in the *operative* provisions of Section 112, and unless those operative provisions render the disputed income non-recognizable it

[3] Compare the administrative rulings of long standing to the effect that the assumption of a mortgage by a purchaser is the equivalent of money which the seller must include in the purchase price when computing gain. G. C. M. 2641, VI-2 Cumulative Bulletin 16; G. C. M. 4935, VII-2 Cumulative Bulletin 112.

[4] Cf. *United States* v. *Phellis*, 257 U. S. 156; *Rockefeller* v. *United States*, 257 U. S. 176; *Cullinan* v. *Walker*, 262 U. S. 134; *Marr* v. *United States*, 268 U. S. 536.

must be taxed under Sections 21 and 22 in the usual manner.

The only provisions in Section 112 that can possibly be invoked to grant the desired exemption are subsections (b) (4) and (d). However, since Borden's consideration for Hendler's assets included not only the assumption of the Hendler debts but also the payment of $43,421.87 in cash to Hendler, it is clear that subsection (b) (4) can have no application. That provision requires that the assets be exchanged "*solely* for stock or securities."

The remaining provision, subsection (d), grants an exemption in the following terms:

> If an exchange would be within the provisions of subsection (b) (4) of this section if it were not for the fact that the property received in exchange consists not only of stock or securities permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then—
>
> (1) If the corporation receiving such other property or money distributes it in pursuance of the plan of reorganization, no gain to the corporation shall be recognized from the exchange, but—
>
> (2) If the corporation receiving such other property or money does not distribute it in pursuance of the plan of reorganization, the gain, if any, to the corporation shall be recognized, but in an amount not in excess

> of the sum of such money and the fair market value of such other property so received, which is not so distributed.

Under this subsection, the great bulk of the $6,608,713.65 profit was exempted. The Commissioner, however, insisted that nowhere in that subsection could there be found any exemption applicable to the item of $534,297.40.

The District Court, after a lengthy analysis (R. 175–177), held that the assumption and discharge of Hendler's bonded indebtedness was not "other property or money" within the meaning of subsection (d). But in spite of that ruling (which would seem to render subsection (d) inapplicable to this controversy and thereby eliminate at once the exemption which is claimed thereunder), the District Court held the item exempt. Although the Circuit Court of Appeals appeared to consider the question whether the disputed item was "other property or money" within subsection (d), it is not entirely clear from its opinion which conclusion is reached.

This item either was or was not "other property or money" within the meaning of subsection (d). But whichever it was, the exemption claimed by respondent does not flow therefrom.

There are, therefore, two reasons for the granting of the writ, one based upon the assumption that the disputed item did not represent "other property or money" and the other based upon the assumption that it did.

Reasons for Granting the Writ.—1. Assuming that the assumption and discharge of Hendler's bonded indebtedness did constitute "other property or money", the claimed exemption follows only if it can be regarded as having been "*distribute*[d] * * * in pursuance of the plan of reorganization." And what constitutes a "distribution" within the meaning of subsection (d) is directly in issue in *Helvering* v. *Minnesota Tea Co.*, 89 F. (2d) 711 (C. C. A. 8th), No. 106, 1937 Term, in which this Court, on October 11, 1937, granted certiorari. In that case a corporation had exchanged its assets, pursuant to a reorganization plan, for stock of the transferee and for cash which it immediately transferred to its stockholders upon condition that they assume its debts. The Circuit Court of Appeals for the Eighth Circuit ruled, (pp. 714–715), that there was no genuine "distribution" to stockholders within the meaning of Section 112 (d) and that the transaction constituted a circuitous retention and application of the money, to the advantage of the transferor company. *A fortiori,* there can be no "distribution" in the instant case, where there was not even in form a distribution to the stockholders.

The Government's brief in opposition to the petition in the *Minnesota Tea Co.* case was filed prior to the decision of the court below, and attempted to distinguish the District Court opinion in the instant case as based on the view that no "other

property or money" had been received by the transferee corporation (Br. p. 9). If the Court of Appeals has ruled that "other property or money" was received, the conflict with the *Minnesota Tea Co.* case becomes clear.

The court below apparently recognized that its decision was contrary to that of the Circuit Court of Appeals for the Eighth Circuit, for it declared (R. 204):

> We have been referred to the decisions in *Helvering* vs. *Minnesota Tea Co.*, 89 F. (2d) 711 and *Liquidating Co.* vs. *Commissioner*, 33 B. T. A. 1173, but insofar as they are at variance with the views herein expressed, we are constrained to disagree.

The decision is also in conflict with an alternative ground of decision in *West Texas Refining & D. Co.* v. *Commissioner*, 68 F. (2d) 77, 80 (C. C. A. 10th). A corporation exchanged its assets for stock in the transferee and cash. The transferor used the cash to pay its debts. The court held that gain could be taxed to the transferor to the extent of the cash received. If, as was held in that case, a payment of its debts by the transferor does not constitute an exempt "distribution," neither does an assumption of its liabilities by the transferee.

In view of the conflict, and in any event in view of the fact that this case presents questions cognate to those which the Court will consider in the *Minnesota Tea Co.* case, we submit that the petition should be granted.

2. Upon the assumption that the item of $534,297.40 did not constitute "other property or money", the decision of the Circuit Court of Appeals plainly calls for review. For, subsection (d) undertakes to deal *only* with the situation where there has been a receipt of "other property or money." And if this item was not "other property or money" subsection (d) can have no operative effect whatever, thereby leaving this item to be dealt with under Sections 21 and 22, as though Section 112 were not part of the law at all.

If this item is not "other property or money", the granting of an exemption by the court below, merely upon the general atmosphere of a reorganization rather than upon the basis of a specific provision authorizing the exemption, is so extraordinary a departure from the terms of the statute as to call for review.

CONCLUSION

Wherefore, it is respectfully submitted that this petition should be granted.

STANLEY REED,
Solicitor General.

NOVEMBER 1937.

APPENDIX

Revenue Act of 1928, c. 852; 45 Stat. 791:

SEC. 21. NET INCOME.

"Net income" means the gross income computed under section 22, less the deductions allowed by section 23.

SEC. 22. GROSS INCOME.

(*a*) *General definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

* * * * *

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges solely in kind.*—

* * * * *

(4) SAME [STOCK FOR STOCK ON REORGANIZATION]—GAIN OF CORPORATION.—No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganiza-

tion, solely for stock or securities in another corporation a party to the reorganization.

* * * * *

(d) *Same [Gain from exchanges not solely in kind]—gain of corporation.*—If an exchange would be within the provisions of subsection ~~(b)~~ (4) of this section if it were not for the fact that the property received in exchange consists not only of stock or securities permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then—

(1) If the corporation receiving such other property or money distributes it in pursuance of the plan of reorganization, no gain to the corporation shall be recognized from the exchange, but

(2) If the corporation receiving such other property or money does not distribute it in pursuance of the plan of reorganization, the gain, if any, to the corporation shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property so received, which is not so distributed.

* * * * *

(i) *Definition of reorganization.*—As used in this section and sections 113 and 115—

(1) The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets

to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected.

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